DOW THEORY LETTERS INC.

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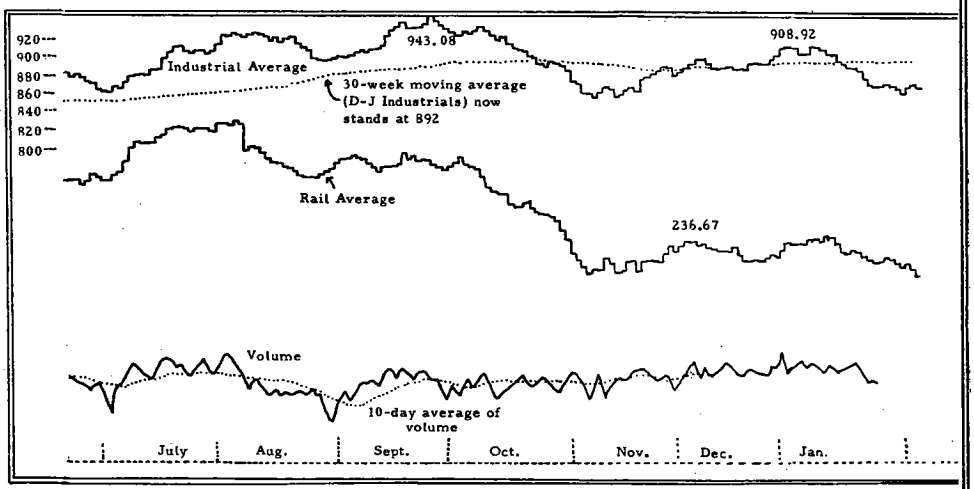
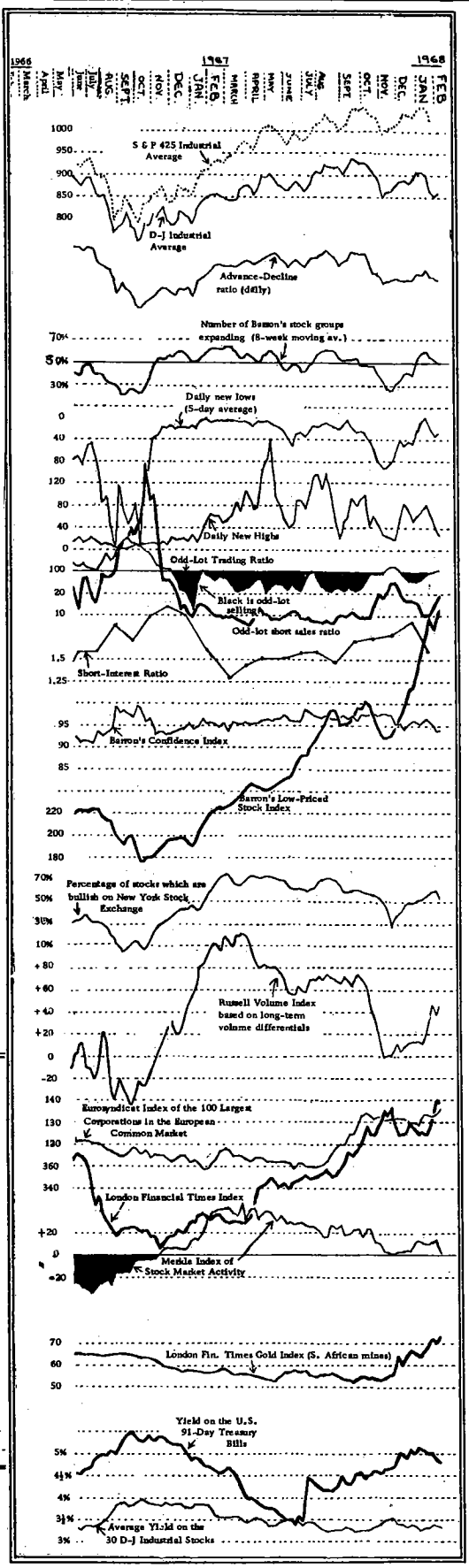
THE MARKET: When wolves attack a deer they tear at its sides and haunches. They tear at its skin and fur, they rip at its antlers, and the deer may well keep running. But when the wolves hit home, when the blood starts flowing, it is only a matter of time until the deer is brought down.

It is the same thing with a nation's finances. When foreigners tear at the U.S. money supply, when they build up huge dollar balances, the U.S. can continue inflating on its merry way. But when foreigners start turning in those dollars for gold, when they start hoarding gold, then the U.S.'s life blood is obviously dribbling away. The measure of wealth, the true measure—is gold. The dollar is fully acceptable as long as it is "as good as gold", but once foreign creditors sense that the dollar is losing its value—that is when they line up to present their claims for true wealth, the gold behind the dollar.

No nation can pursue a "pie-in-the-sky" domestic policy, then fight a fantastically expensive war on top of that—unless it enjoys an almost impregnable financial position. The implications of the wildly expensive "guns and butter" policy which the U.S. has been following has always been that something was going to give. That "something" is the dollar. The dollar is hemorrhaging, and uneasy foreigners with $30 billion worth of claims are watching the approximately $10 billion of available U.S. gold (available assuming the gold cover is removed). And foreigners must have queasy feelings as they mull over the fact that there are $3 of claims for every $1 worth of the biggest commodity bargain of 1968. Who will panic first? Which Central Bank will jump the gun and grab for its gold while that gold is still there for the grabbing? Which foreign nation (perhaps sensing a coming U.S. gold embargo) will seek to protect itself by turning its whole dollar collection in for gold?

And the Communists, don't they see the picture? Aren't they figuring how to topple the dollar and extend their influence while the U.S. (like Britain) is protecting its currency by retrenching? Or if no retrenchment is in the cards, won't the U.S. make a deal rather than see its currency collapse? Why not start trouble in Korea, why not stir up Laos, Cambodia, Thailand, Israel? Why not indeed! Stirring up trouble—and expensive trouble—is exactly the policy the Communists are following.




1966
1967
1968
S & P 425 Industrial Average
D-J Industrial Average
Advance-Decline ratio (daily)
Number of Barron's stock groups expanding (8-week moving av.)
Daily new lows (5-day average)
Daily New Highs
Odd-Lot Trading Ratio
Black is odd-lot selling
Odd-lot short sales ratio
Short-Interest Ratio
Barron's Confidence Index
Barron's Low-Priced Stock Index
Percentage of stocks which are bullish on New York Stock Exchange
Russell Volume Index based on long-term volume differentials
Eurosyndicat Index of the 100 Largest Corporations in the European Common Market
London Financial Times Index
Merkle Index of Stock Market Activity
London Fin. Times Gold Index (S. African mines)
Yield on the U.S. 91-Day Treasury Bills
Average Yield on the 30 D-J Industrial Stocks

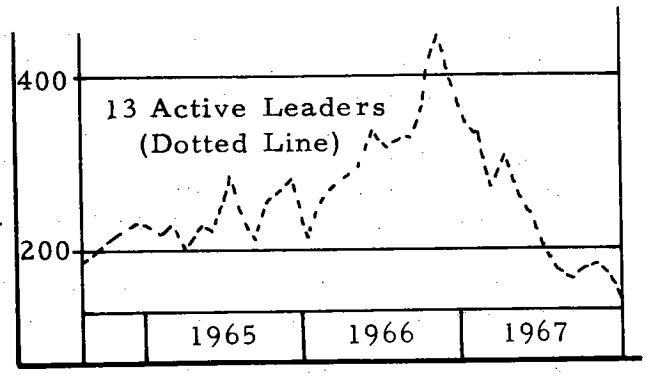
 The pitiful fact is that there is more justification for war against North Korea now than there ever was against Vietnam. But North Korea obviously understood the U.S. predicament, they knew that the U.S. could not afford a further escalation of the Asian mess. The spectacle of the world's greatest power bargaining and pussyfooting for the return of its own ship is degrading. But that is what happens when you've been living over your head for decades, and you consequently have to protect your currency instead of your interests. Any Englishman can tell LBJ all about it.

Turning to Wall Street itself, the last few Letters of 1967 suggested waiting for January, 1968, in order to ascertain the true trend of the market. The January performance of the market has not been favorable. Following the year end rally which was characterized by record-breaking volume on both the N.Y.S.E. and the Amex, the market topped out during the first two weeks of 1968. On January 22 the Industrial Average actually broke below its December low of 879.16. Two days later, on January 24, the Rail Average confirmed by violating its own December low of 230.20.

Thus, the entire 1967 year end rally was erased before the month of January 1968 was over, as the market wallowed in a sea of worries regarding Vietnam, Korea, balance-of-payments, inflations, gold losses and propaganda from a President who seems incapable of dealing with the real problems (as note his State of the Union address).

Judging from the past, in such years as 1953, 1957, 1960 and 1962, when the December lows were penetrated in January, the implications were negative for the general market. I suppose it is fair to say that when the January market erases all the gains of the previous year end, it is reappraising the prospects for the coming year, and when that reappraisal is sufficiently bearish to take the Averages below the preceding December lows, the market is saying that it does not like what it sees ahead.

A few technical considerations are in order. Odd-lotters have switched rather dramatically to the buy side over the past 10 days. Thus, the public considers declining prices an entry by the market into the "bargain area." This is decidedly negative for the market as a whole. Secondly, much of the speculative zip has gone out of Wall Street as assorted conglomerates and glamour stocks have been hit hard. Since the backbone of the recent rise was almost entirely speculative, I consider it negative when that backbone is broken.



Finally, I was most interested in Garfield Drew's latest chart of the short position in his "13 active leaders." This chart shows a representative true short position on the N.Y.S.E., minus all the arbitrage and stock splits. Note that the short position in the active leaders has dropped to a four year low. Thus, the short position as suggested on Drew's chart is now a negative technical consideration for the market.

Looking ahead, there is no question of the importance of the November, 1967 lows. Those lows were 849.57 for Industrials, 227.88 for Rails. The rally since the November lows lasted 9 weeks in duration. The rally recouped 63% of the preceding September-November decline for Industrials, it regained 22% of the same decline for Rails. The rally (see chart 1) served as a full secondary correction of the primary decline from the September 25, 1966 high (943.08 for Industrials) to the November low (849.57).

If the two Averages now break through the respective 849.57 and 227.88 lows established in November, it will be a full reconfirmation of the primary bear trend. Any such penetration, if it occurs, will be a most unfavorable omen and would in all probability predict vastly lower prices for the general market.

DOW THEORY THOUGHTS: I often mull over what I term "the theory of markets". One thing that I have given a good deal of current thought to is the whole structure of the market since 1949. The three-phase bull market of 1949-66 ran like this. The first phase lasted from 1949 to 1953, perfectly normal. The second (usually the longest) phase lasted from 1954 to 1958. The third speculative phase ran from late-1958 to 1966, an unprecedented 8 years. Thus the final speculative phase of the bull market ran better than twice as long as the other two phases, but in past history the third phase of a bull market is almost always the shortest phase.

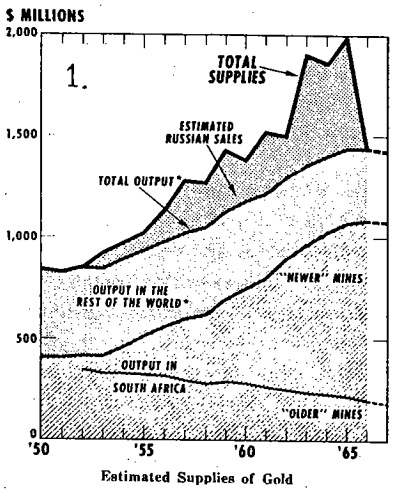
Turning to the bear market, the first phase ran from February, 1966 to the end of the year. The second phase began in October, 1966. By my reckoning, we are still in the second phase of the bear market, and this is the phase in which the market ultimately goes down in response to obviously deteriorating business conditions (and in today's case a deteriorating business climate). The termination of the second phase should see the Dow well under the 1966 low of 744.32. The second phase low could come any time in 1968 or perhaps in early 1969. The second phase of this bear market (so far) has been "absurd" in many ways, not the least of which was the huge, inflation-speculation sponsored rally.

Then we come to the final third phase. I wonder if the third phase of this bear market will not be just as "different" as the whole bear market has been so far. It is entirely possible that the third phase will be long and drawn out, and just as atypical

a structure as was the structure of the final third phase of the 1949-66 bull market.

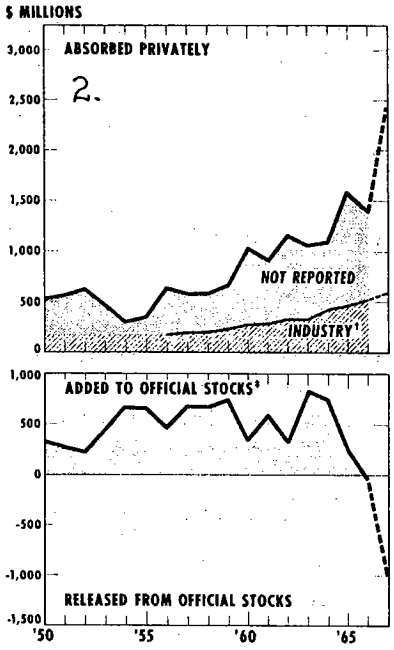
Normally, the third phase is the one in which stocks go down on low volume, the market thereby eventually taking shares below "known values." I believe that one possibility during the coming third phase could be extension. That is that the third phase could be the real bear market phase, longer than the other phases and percentagewise the phase that witnesses the most drastic declines. This is all theory, of course, but I thought subscribers should be aware of some of the thoughts on my mind. It should be remembered that this bear market has been very atypical so far. It could well continue that way.

GOLD: Aside from the politico-power considerations, as discussed above, the facts of gold alone are militating steadily towards a price increase in the yellow metal. The accompanying charts from the First National City Bank tells a rather grim story. As the Bank's latest report notes, "For the first time in modern history, the international monetary system is....left to work with declining gold reserves."



Estimated Supplies of Gold

Since December, 1966, official world gold reserves have actually declined 2.5% (see chart 1). This is due to (1) a leveling off of South African gold output, (2) the explosion in private demand for gold (see chart 2), with 1967 alone having seen $2.5 billion of gold disappear into private hoards, (3) the increasing industrial use of gold, (4) the preference for gold rather than reserve currencies by the Central Banks. In the 10 years ending 1966, for instance, 90% of the additions by the Common Market nations to their gold and foreign exchange reserves was in the form of gold.



The First National City Bank's annual "Gold Review" appears in the current January issue. I thought the review was particularly interesting because the Bank has been a promoter (like almost all the banks) of "funny money" or S.D.R.'s or anything which will take us away from the discipline of gold. But in the current issue, the Bank first notes that the U.S. gold stock is at its lowest level in 30 years and that it now represents....."some 30% of the world monetary gold stock compared with 70% in 1949 at a time when the world was plagued with what many regarded as a structural shortage of U.S. dollars."

Then the Bank states: "Specifically, unless gold is demonetized by international agreement—something the nations holding the bulk of their respective reserves in the form of gold in preference to dollars would obviously be unwilling to accept—the U.S. needs a gold reserve commensurate with its far-flung international responsibilities. It also needs gold for emergencies—at times and circumstances where no other money will do since gold alone is universally acceptable. Beyond that, there is the importance of gold as a war chest."

Having practically stated the case for gold, practically admitting that Europe will not accept paper reserves, the Bank comes to a complete dead end. They offer no suggestions except to emphasize the danger of the current situation.

Reading between the lines, I believe that the First National City Bank of New York and many of the other banks and bankers are beginning to see that (if no other reason than sheer practicality and necessity) the price of gold must be raised. After all, if you cannot do away with gold and if you can't do without it, the only thing left is to raise its price. There is no other way (acceptable to the majority of nations) left to raise the value of the world's reserves. And we should never underestimate the influence of the banking community on the monetary policies of our Government.

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Incidentally, I include this little squib from the January 26, Miami Herald. It is of interest because this statement is not the sort of thing we would have read and it is not the sort of thing the Governor of Florida would have said a year ago or even six months ago. The times are a-changin'. (See top right of page 4).

POWER POLITICS: I was most pleased to note publication of friend Eliot Janeway's important new book, "The Economics of Crisis." I was just as pleased to see the two-page write-up of Janeway in the January 29 issue of Newsweek. Janeway believes that the Vietnam War constitutes the worst financed (if it can indeed be called "financed") war in American history. Escalation in Vietnam, says Janeway, means deterioration for the dollar. Particularly since neither LBJ nor McNamara ever

 let Congress in on their Vietnam plans and the war was therefore never financed.

Now Janeway states that the overextended U.S. position leaves the U.S. open for the next Russian power play in the Mediterranean or the Middle East or both. Furthermore, all that is preventing a second pound devaluation is the fact that Arabs have not yet pulled their sterling balances out of London. Russia (and France) have now moved into the oil shieks' camps, and it remains for the Arabs (actually Russia) to decide whether sterling stays in London or leaves.

The consequences, says Janeway, are that the U.S. and Britain are now in the position of having to give costly concessions to Russia in order to keep the Arab sterling balances in London. If the sterling goes, the pound goes and the dollar will come under immediate mountainous pressure. Of course, France, which wants to disprove the myth of dollar invincibility, would like nothing more than a fall of the dollar and a return to the gold standard.

Thus, the play is up to Russia. The Russians want U.S. expenses (escalation) to keep mounting (to be coldly stark about it, Korea is probably part of the Russian "escalation plan" for the U.S.), but the Russians also want to stop just short of World War III. The price for a "deal" with Russia will probably be a turnover to Russia of much of the power in the Mediterranean (making the Mediterranean "Russia's new lake," as Janeway puts it).

CHICAGO — (AP) — Florida's governor, Claude R. Kirk Jr., Thursday urged a multilateral revaluation of gold at $70 an ounce in agreement with all major trading nations of the free world and under auspices of the International Monetary Fund.

KIRK

"If we do this, there will be no devaluation but only revaluation," he said. "There

It is ironic that Russia and France have different goals, but their means towards those goals are much the same. Russia wants Mediterranean and Middle East power, while France wants a higher price for gold plus a concurrent toppling of the dollar (and an end of the dollar as a reserve currency). The U.S. has allowed itself to be shoved in the "squeeze play," it has let itself be embroiled in the costly Vietnam venture, with Korea opening up a second round of costly expenses plus the new added expense of the U.S. having to step into the vacuum left by the British preparations to evacuate all stations east of Suez.

I have written before to the effect that Vietnam is part of a Communist economic battle, a battle which will have political consequences of the most drastic kind— but nevertheless the war is essentially economic from the Communist point of view. And make no mistake about it, Korea is part of this continuing economic war as may well be Laos, Cambodia and Thailand.

The U.S. has fallen into the twin traps of allowing their currency to weaken via (1) inflation and mismanagement, (2) assuming military ventures which were not financed at all, and which (even if properly financed) would have had the effect of at least weakening the dollar. The asanine "guns-and-butter" policy of the Johnson Administration in the face of Communist expansion of the military front and in the face of French attacks on the dollar is calculated (at least by this writer) to be the road to disaster. It is all a great deal bigger than simply a military war.

NOTES AND QUOTES: Fortune Magazine (new issue) in a rather rare mood, castigates Secretary of the Treasury Fowler, and notes that under Fowler's inept hands the Treasury Department has suffered a "grievous decline in influence, talent and prestige." Fowler is accused of going too far to please LBJ, and in so doing the Treasury has lost "the confidence of most of the business and financial community." Finally Fortune states that Fowler is guilty of the same "dissembling and secrecy and last minute improvisations of economic and fiscal matters that have become standard Johnsonian practice."

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In an embarrassingly and frighteningly candid article, the Wall Street Journal (January 29) documents the "Second-Front Strain" under which the Korean incident has now placed us. Many of the F100 and F102 planes have been taken from the reserves and placed in Vietnam, leaving the reserves with F86 fighters of Korean war vintage. The huge build-up in Vietnam has used 40% of our combat-ready divisions, 50% of our air power and over one-third of our naval power. The U.S. has kept only 2 dozen combat aircraft in S. Korea and only two divisions. Against this the North Koreans can muster over 400 combat planes and a total army of around 1.2 million men. With few available men or arms nearby, a breakout of war in Korea would mean that the U.S. would have to ship men and equipment 10,000 miles to supply a second front. Is it any wonder that LBJ is going cautiously. Vietnam has given us no other choice, and the Russians and the North Koreans know it.

* * * *

Johnson's latest concession is that if the North Vietnamese will agree to negotiate, the U.S. will stop bombing the North while allowing the North Vietnamese to continue the war and infiltration as they see fit. As this is written, Hanoi has not shown any interest in the new concession. More and more, it appears to this writer that Hanoi is showing a willingness to continue until they can extract the most extreme concessions—which would possibly mean a wholesale U.S. exit from all of Vietnam.

NOTICE: With this mailing I am announcing the termination of the Economic Trend Letter and also a severing of connections with Mr. Michael Holzman. Economic Trends Letter may be continued or resurrected some time in the future, but it did not turn out the way I hoped it would. On top of this, Mr. Holzman and I entered into a series of personal disagreements, and this made for further complications. I want to state that there is now no connection between Dow Theory Letters (or Dow Theory Economic Trends Letter, which name I own) and Mr. Michael Holzman. Nor do I assume responsibility for Mr. Holzman's activities now or in the future. (Continued on Market Laboratory Page).